

Credit-based Insurance Scoring: Why Latinos Pay More for Auto Insurance Than They Should

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Submitted by:

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INTRODUCTION

My name is Eric Rodriguez, Deputy Vice President at the National Council of La Raza (NCLR), the largest national Latino civil rights and advocacy organization in the United States. For more than 12 years, I have prepared policy analyses and conducted direct legislative and advocacy activities on economic and financial security public policy issues. One important part of NCLR's mission is to carry out public policy and programmatic initiatives that improve the opportunity for and the ability of Hispanic* families to build wealth and move permanently into the ranks of the American middle class. There are now more than 44.3 million Latinos residing in the U.S., and their purchasing power was estimated at nearly \$800 billion in 2006. However, the most recent household wealth survey shows that the median net worth of Hispanic households is \$7,932, compared to \$88,651 for White non-Hispanic households.¹ Given the importance of addressing the nation's racial and ethnic wealth gap, we thank Chairman Watt (D-NC) and Ranking Member Gary Miller (R-CA) for inviting us to provide expert testimony for the hearing entitled, "Credit-Based Insurance Scores: Are they Fair?"

CREDIT SCORING: A STRUCTURAL BARRIER TO WEALTH FOR LATINOS

NCLR has closely examined financial markets as a means of better understanding wealth disparities. This body of work includes the preparation and release of articles, papers, reports, and other written analyses about how Latinos participate in the mainstream financial services industry. For example, NCLR prepared *Jeopardizing Hispanic Homeownership: Predatory Practices in the Homebuying Market* (2005) and *Latino Credit Card Use: Debt Trap or Ticket to Prosperity?* (2007), two issue briefs that identified how policy and practice within the mortgage lending and credit card industries adversely impact Latino consumers. NCLR also released two other notable papers, *Reforming the Remittance Transfer Market* (2005), and *Financial Counseling: A Meaningful Strategy for Building Wealth in the Latino Community* (2005).

NCLR's assessment is that disparities in wealth between Hispanic and White households have more to do with economic and structural barriers within U.S. financial markets than cultural or language barriers. This perspective is discussed in more detail in the article, "Closing the Wealth Gap: Eliminating Structural Barriers to Building Assets Within the Latino Community," published in the current edition of the *Harvard Journal of Hispanic Policy*.

In the U.S. financial market, credit scores are the key to unlocking the door of economic opportunity for American workers and families. A person's credit score can influence a broad range of job and financial opportunities. Given the uneven distribution of wealth opportunity among American workers, more attention has been paid in recent years to the way in which the market determines the creditworthiness of consumers. A number of studies have found that minorities are overrepresented among those with poor credit scores and that credit scoring disproportionately impacts minorities.²

* The terms "Hispanic" and "Latino" are used interchangeably by the U.S. Census Bureau and throughout this document to identify persons of Mexican, Puerto Rican, Cuban, Central and South American, Dominican, and Spanish descent; they may be of any race.

For lenders, credit scoring systems have helped to decrease costs and the time it takes to evaluate a potential customer's creditworthiness. However, because mainstream financial institutions overly rely on credit scoring to determine creditworthiness, Hispanics, who tend to be nontraditional borrowers, are disproportionately and adversely impacted. Individual credit records that have limited information (so-called "thin" files), or no information (so-called "no hits" because they generate no credit score), are often designated as high risk by financial institutions or would-be creditors.

The result is that far too many Latinos, those who pose a low credit risk and should be eligible for the most affordable products and services in the market, are pushed unnecessarily into high-cost and fringe financial markets where predatory lenders await. For example, research by the Center for Responsible Lending shows that Latinos are 30% more likely than Whites to receive a high-cost loan when purchasing a home. Moreover, about two in five mortgage loans made to Latinos are subprime.³

The experience of Latinos and other minorities, and the research to date, cast serious doubt on the fairness of credit scoring models. For this reason, in 2003 Congress mandated an examination of credit scoring and its impact on consumers. The Federal Trade Commission (FTC) was required to study credit-based insurance scores and the impact on the availability and affordability of financial products. In July 2007, the FTC released the report, "Credit-based Insurance Scores: Impact on Consumers of Automobile Insurance." The report deserves great scrutiny and has added to the debate over credit scoring's role as a barrier to wealth for minorities.

AUTOMOBILES, INSURANCE, AND LATINO WEALTH

More Latinos today own cars than they do homes. Industry policy and practice in the car-buying, auto finance, and auto insurance fields have a widespread impact on the Hispanic community. According to a 2002 study by the Pew Hispanic Center, almost 80% of Latino households reported owning at least one car, compared to 67.8% of non-Hispanic Black households and 88.3% of non-Hispanic White households.⁴ In contrast, in 2007 only half of Latino households own their own homes compared to more than three-quarters of non-Hispanic Whites.⁵ Moreover, for many Latinos a car is their only asset. The Pew study found that 25% of Latinos owned no assets other than a vehicle or unsecured liabilities, compared to 6% of Whites.

In addition, Latinos tend to pay more than necessary to finance their car. Data from one major vehicle financing company show that, regardless of creditworthiness, Latino borrowers paid, on average, \$266 more in finance costs per loan than non-Hispanic borrowers.⁶ Collectively, these Latino borrowers paid \$36 million in additional charges.⁷

With respect to both homeowners and auto insurance, there is a long and sordid history of redlining and racial/ethnic discrimination. Policy and practice in the industry have evolved over the decades, but research still finds that minorities pay more than their White peers for insurance. For instance, regarding car insurance, Consumers Union recently released a study which examined data from a number of insurance companies and found that good drivers in the predominantly African American and Latino communities of Baldwin Hills and Inglewood

(California) pay \$951 and \$899, respectively, more for insurance than the same good driver pays in Westchester, which is predominantly non-Hispanic White. Similarly, in the majority Latino 95205 ZIP Code in Stockton (California), good drivers pay \$252 more per year than drivers in the adjacent and largely non-Hispanic White 95204 ZIP Code in Stockton.

Across the board, Latinos are paying more than their White peers to own a car, and the resulting cumulative loss of income and assets from Hispanic households undermines their ability to advance economically into the ranks of the American middle class.

THE PROBLEM WITH CREDIT-BASED INSURANCE SCORING

Credit-based insurance scoring is unfair to Latinos. The principal problem lies in the inaccurate assumptions built into traditional scoring models. The value of scoring is in the ability of a number to reflect a person's actual credit risk, as demonstrated by an individual's behavior or "performance." With respect to Latinos, for a number of reasons credit information is limited; as a result credit scores are a poor predictor of actual creditworthiness.

Gap Between Credit Scores and Creditworthiness

The assumption in traditional credit scoring models is that creditworthiness can be assessed by examining a person's record of making timely payments to many different creditors, and to a lesser extent, the amount of assets held in financial institutions. Insurance scoring models can use any number of credit-related factors to determine a score. Credit factors that could be used include the number of accounts opened, age of oldest accounts, number of credit card accounts opened, or number of department store accounts. Many creditworthy Hispanic families, especially those that include immigrants, are inaccurately and unfairly deemed "high risk" because of this operating assumption. For example, families may be financially conservative and risk averse and avoid opening up credit card accounts. But the very fact that they decline to assume personal or household debt should make them less, not more, of a credit risk than comparable non-Latino families.

Many such households live in extended families where incomes are pooled from multiple wage earners. In such cases, the absence of or having only a "thin" credit file is compounded by the failure of traditional models to attribute all the available income to the household. Similarly, many of these families remit funds to family members abroad, not just for subsistence but also for investment purposes. These families are doubly penalized in that conventional models do not reward their deferred consumption and do not take into account the value of assets held abroad. In sum, by living modestly, declining to accept debt, pooling resources, deferring consumption in favor of savings, and investing abroad, perhaps half of Latino households are penalized instead of rewarded by traditional credit scoring systems.

Moreover, the inaccuracy of credit information in credit reports further penalizes these families with disproportionate adverse effects. Studies show that 29% of consumer credit scores differ by 50 points between credit bureaus.⁸ This may not matter for a high-scoring consumer, but could inaccurately place millions of other consumers unfairly into subprime ratings. Furthermore, studies show that 50% to 70% of credit reports contain inaccurate information regarding a

consumer's general credit history.⁹ There is also no requirement for lenders to weigh all three credit scores to determine the creditworthiness of potential customers. Also, most credit scoring models collect only limited information on other data that could demonstrate creditworthiness, such as utility bills. A study by The Brookings Institution found that Hispanics experienced a 21% increase in acceptance rates (a meaningful improvement in their creditworthiness and risk assessment) when nontraditional payment data were factored in.¹⁰

Impact of No Credit Score and "Thin" Credit Files

A study by The Brookings Institution found that approximately 35 million to 54 million Americans remain outside of the credit system.¹¹ The Information Policy Institute reported data from the credit bureau Experian showing that 18 million credit-eligible Americans had credit files too "thin" to score and another 17 million had no files.¹²

The problem of "thin" and no credit files is particularly acute among immigrants and many Hispanic households that include both native and foreign-born individuals. According to a study by the Center for Community Capitalism, 22% of Hispanic borrowers had no credit score compared to 4% of Whites and 3% of African Americans.¹³

Moreover, Latinos are more likely than their peers to have no credit score or a "thin" credit file for a number of important reasons, including the following:

- **A substantial share of Latinos are unbanked.** The principal data furnishers to credit bureaus are mainstream creditors. Research and data reveal that more than one-third of Hispanics lack a basic checking or savings account.
- **Latinos tend to be young and many are foreign-born and new to U.S. financial markets.** Credit scoring models heavily weigh variables such as the average number of months that accounts have been on file and the age of the oldest accounts (i.e., length of credit history). These factors favor older consumers and those with a long-standing presence in the market. About 45% of Latino adults in the U.S. are foreign-born and more than half of Hispanics, whether native or foreign-born, are under the age of 27.
- **Latinos are less likely than their peers to use credit cards.** Credit card issuers are important sources of credit information to credit bureaus. Only 56% of Latino households report having a credit card, compared to 80% of all households.
- **The use of Social Security numbers as an identifier by credit bureaus limits the ability of some foreign-born residents to accumulate a payment history.** Nearly half of Latino adults in the U.S. are foreign-born and several million do not have Social Security numbers, a principal means of recording and reporting consumer payment data with credit bureaus.

Finally, because Latinos have lower homeownership rates, only roughly one-third are making steady mortgage payments, and surveys confirm that, on the whole, Hispanics tend to be risk averse and proportionately less likely to carry debt.

Notwithstanding these factors, the report on credit-based insurance scores released in July 2007 by the FTC reported a small share of the overall population with no credit scores. More incredibly, the FTC study found that it was more difficult to find credit reports for African Americans than for Latinos. According to the study, credit reports could not be located for 9.2% of the Hispanic population compared to 9.7% of African Americans and 7.8% of non-Hispanic Whites.¹⁴ These obviously flawed data led the FTC to conclude that not having a credit score was unlikely to be an important source of difference in auto insurance premiums among racial and ethnic groups.

Despite that anomaly, the study did find that consumers for whom scores were not available appeared riskier when scores were used than when scores were not. In this case no credit record, rather than a record of relatively poor repayment of debt, automatically resulted in a "high risk" designation within insurance scoring models. This finding, coupled with the results of the Federal Reserve study on credit-scoring, documents the problem for Latinos. The Federal Reserve confirmed that foreign-born consumers consistently performed better than predicted by their credit scores. As the studies reveal, credit scoring adversely, unfairly, and disproportionately impacts those who are young and foreign-born, a substantial share of the overall Latino population.

Role of Limited Information

Information about how credit-based insurance scoring models work and how they impact different segments of consumers is limited. The FTC study is a reflection of how closely guarded insurance companies keep this information and how little we know. In particular, it is extremely difficult for regulators to effectively conduct oversight without some further measure of transparency from those using credit-based insurance scoring models.

Moreover, it is virtually impossible to effectively "shop" for the best insurance policy when basic pricing information is unclear or not communicated by companies. In the case of credit cards, the data strongly suggest that Latinos are much less likely than their peers to shop for the best terms. Undoubtedly, many Hispanics are unaware that they are paying much more than their peers – and much more than they should – for car insurance.

CONCLUSION AND POLICY RECOMMENDATIONS

Hispanics have experienced a long history of exploitation and discrimination at the hands of insurance agents and companies, which is how insurance redlining emerged as a major civil rights issue. Insurance scoring does have the benefit of removing a measure of discretion that in the past resulted in outright discrimination against Latinos. However, persistent imperfections within insurance scoring models undeniably results in Latinos and African Americans paying more for insurance than their White peers. That alone ought to raise caution flags for industry, regulators, and policy-makers. The FTC study reveals that the use of credit information in insurance scoring models is now ubiquitous and that while many states have taken steps to address public concerns about this development, state policy is inconsistent. Until the credit recording and reporting system materially improves the quality of information for nontraditional

borrowers, the insurance industry should be barred from using it within insurance scoring models. Unquestionably, there should be a prohibition against using credit information for those consumers who have no credit score or "thin" credit files. Other recommendations worth considering include the following:

- **Improve consumer information.** For insurance companies that use credit information, require that the exact credit-related reason for rate changes or denial be included in consumer notices, along with steps consumers can take to remedy errors.
- **Improve transparency.** For companies that use credit-based insurance scoring models, require data reporting to regulators on rates and claims disaggregated by race and ethnicity, similar to that employed in the Home Mortgage Disclosure Act.
- **Improve oversight.** Require all companies to register their insurance scoring models with federal and state regulators.
- **Develop a more rigorous regulatory enforcement regime.** To ensure an insurance market free of discrimination or policies that have clear disparate impact on minority consumers, a new regulatory framework is needed to monitor and provide redress against such policies.
- **Encourage voluntary improvements in credit-scoring models.** Partnerships and pilot projects should be encouraged between industry and nonprofit organizations which test models that more accurately take into account the actual behavior of nontraditional borrowers.

Finally, NCLR strongly supports the creation of a network of community-based financial counselors to provide basic financial advice for low-income families. In the absence of effective policy and regulatory oversight, more needs to be done to empower low-income Latino consumers. Research demonstrates that one-on-one counseling is an effective, and perhaps the *only* effective, approach for doing this.

¹ Kochhar, Rakesh, *The Wealth of Hispanic Households: 1996 to 2002*. Washington, DC: Pew Hispanic Center, 2004.

² Wu, Chi Chi with Birny Birnbaum, *Credit Scoring and Insurance: Costing Consumers Billions and Perpetuating the Economic Racial Divide*. Center for Economic Justice, National Consumer Law Center, June 2007.

³ Bocian, Debbie Gruenstein, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on Price of Subprime Mortgages*. Center for Responsible Lending, May 2006.

⁴ *The Wealth of Hispanic Households, op.cit.*

⁵ U.S. Department of Housing and Urban Development, *U.S. Housing Market Conditions*, 2nd Quarter 2007.

⁶ *The Hidden Markup of Auto Loans: Consumer Costs of Dealer Kickbacks and Inflated Finance Charges*, Consumer Federation of America, January 26, 2004.

⁷ *Ibid.*

⁸ Carter, Carolyn, Elizabeth Renauart, Margot Saunders, and Chi Chi Wu, "The Credit Card Market and Regulation: In Need of Repair," North Carolina Banking Institute, Vol. 10, March 2006. Citing Consumer Federation of America study.

⁹ *Ibid.*

¹⁰ *Give Credit Where Credit Is Due: Increasing Access to Affordable Mainstream Credit Using Alternative Data*. Political and Economic Research Council and The Brookings Institution Urban Markets Initiative, 2006.

¹¹ *Ibid.*

¹² *Giving Underserved Consumers Better Access to the Credit System: The Promise of Non-Traditional Data*. Information Policy Institute, July 2005.

¹³ Stegman, Michael, et al., "Automated Underwriting: Getting to 'Yes' for More Low-Income Applicants," Presented before the 2001 Conference on Housing Opportunity, Research Institute for Housing America Center for Community Capitalism, University of North Carolina-Chapel Hill, April 2001.

¹⁴ *Credit-Based Insurance Scores: Impact on Consumers of Automobile Insurance*, A Report to Congress by the Federal Trade Commission, July 2007.